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The Manufacturers Hanover
Economic Report

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CRA Is Not The Way

The failure of interest rates to fall in the face of deepening recession, growing financial strains in the private sector and a much-subdued rate of price inflation has, quite understandably, led to a lot of finger-pointing. Most of this appears to be aimed in the direction of the Federal Reserve, in the belief that it must bear the ultimate responsibility for the availability of money and its price in the United States.

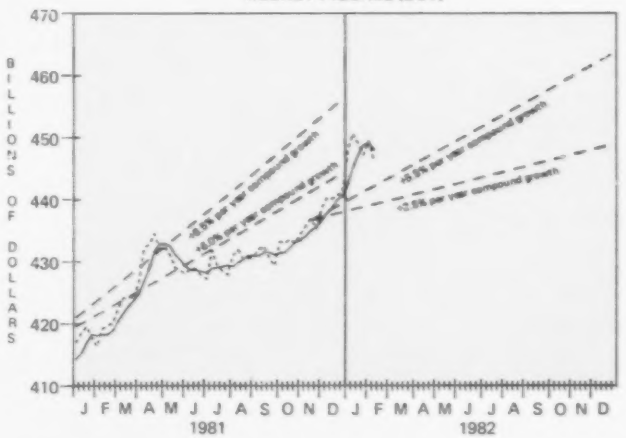
Complaints are being levied that the Fed's inability to promote stable growth in the supply of money and credit has produced such erratic interest rates that the financial markets have added a sizable volatility premium to the "real" rate of return they usually demand for investing funds, besides their expectations about inflation. In turn, these high "real" interest rates are making it increasingly difficult for businesses to borrow, since they can neither absorb these costs, nor pass them on. Additionally, they present an unusually high "hurdle" rate that must be surmounted before any thought of capital spending — the sine qua non for revitalizing the private sector — can take place.

Thus, in order to get financial market participants to lower the volatility premium now embodied in both short- and long-term rates, a number of observers have begun to offer advice to the Federal Reserve concerning how to stabilize money growth (Chart I). Not the least of these is President Reagan's Council of Economic Advisers. In its Annual Report for 1982, the Council asserts that the Federal Reserve would be able to exercise greater control over the monetary aggregates by switching from lagged reserve accounting (LRA) to contemporaneous reserve accounting (CRA). Let us examine this proposal to see if it, indeed, would help reduce monetary volatility.

The Role of Reserves

To enhance the Federal Reserve's ability to control the nation's supply of money and credit, commercial banks and other depository institutions must hold some of their assets in the form of reserves. These reserves can consist of vault cash or deposits at a District Federal Reserve Bank. Their size is determined by the average level of deposit liabilities the banks had on hand two weeks earlier — hence the term "lagged reserve accounting." They consist of two types: nonborrowed, which are owned outright by the banks and are acquired through Federal Reserve open market operations; and borrowed, which are obtained via a loan from the discount window of the Fed. To effectively control money growth, the Federal Reserve must be able to control *both* components of member banks' reserves — nonborrowed and borrowed.

CHART I
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE) VS.
WEEKLY FIGURES (DOT)



Those who advocate a change (actually, a return) to CRA believe that such a system would improve the Fed's ability to control growth of the money supply. This is because it would allow open market operations of the Fed to have a more immediate effect on total bank reserves — especially important because the Fed has been trying to target reserves since October, 1979.

Under LRA, the banks' levels of required reserves are determined by deposits held two weeks earlier. By law, the member banks in the system must be able to come up with their required reserves. In the short run, all the Federal Reserve can do is determine how these reserves are composed — either borrowed or non-

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borrowed. CRA advocates feel that the Fed's ability to influence total reserves in the banking system is constrained by the LRA system. In the very short run, the Fed is, in effect, a passive supplier of reserves either through open market operations or the discount window — in effect, validating portfolio and asset decisions already made by the commercial banks.

If the Fed wanted to alter monetary policy — say in the direction of slower growth of money — the LRA system delays the receipt of this signal by the banks. By the same token, the banks' reaction can be delayed as well. Because of these lags, CRA advocates assert that the Fed's control over the money supply has been erratic over periods of time as long as several months. And because the Fed releases these data weekly, financial market participants are able to plot them against the central bank's stated targets for growth thus jumping to conclusions in one week which may be reversed the next. This has allegedly produced a good deal of the volatility we've seen in interest rates of late and is supposedly responsible for the failure of interest rates to fall during a period of recession and reduced inflation.

These arguments sound mighty compelling — especially since money growth has not been stable. The question is — will a return to CRA enhance the Fed's ability to control the money supply and what costs would be involved in the process?

Plusses and Minuses

In my view, there is little to be gained from a change toward CRA — but a lot that could be lost in the form of greater uncertainties and increased volatility in the financial markets. First of all, CRA won't change the fact that the banking system cannot fail to meet its legally binding reserve requirements. If the banks can't obtain needed reserves in the Federal funds market, they must turn to the Fed and borrow at its discount window. As the banking system's only source of reserves, the Fed cannot avoid satisfying banks' needs for reserves. This is the case today, under LRA, and it would be the case under CRA as well.

The only difference under CRA is that both the banks and the Fed would have less time to adjust to changes in the banking system's needs for reserves. This would lead to more volatility and uncertainty in the money markets. And while CRA had been used until 1968, in those days, the Fed's policy was to manage interest rates, thus smoothing out financial market volatility. Today, because the Fed no longer pays much attention to interest rates, markets are already volatile, thus any shift toward CRA would only exacerbate the situation.

While adopting CRA might reduce somewhat the tendency of the banks to "force" the Fed to supply reserves required to support portfolio and asset decisions made two weeks earlier, this could backfire for several reasons. First, to the extent sudden asset adjustments have to be made (i.e.: fewer loans or reductions in credit lines), the banks will lose even more of their lending business to other markets (commercial paper, foreign banks, etc.) than they already have. This, in turn, would loosen, rather than tighten, the Fed's control over monetary policy, and monetary policy's relationship, in turn, with aggregate economic activity, inflation, etc.

Second, to forestall such unpredictability (which would anger not only their customers, but the banks' own lending officers as well), bank senior managements would probably decide to hold excess reserves with the Fed. This would give them leeway to avoid making sudden asset shifts, but would cut into their profitability — not to mention the Fed's control over the aggregates. Third, as long as reserve requirements vary among different categories of bank deposits and other non-deposit liabilities, there is nothing in CRA that would prevent the banks from changing the composition of their liabilities in order to free up reserves. This could be accomplished by intentionally offering their customers incentives to shift deposits. Such shifts may also result from wholly independent actions of the non-bank public for reasons that neither the banks nor the Fed can anticipate.

This brings to mind another argument against CRA — the fact that, in the short run, the Fed's control over the money and reserve aggregates could be altered by actions taken by commercial banks, the non-bank private sector, and the Treasury. Commercial bank reserve demands can be unexpectedly affected by changes in such operating factors as currency in circulation, "float" and Treasury balances at the Federal Reserve banks — the impact of which even the Fed is unaware of, at times, until after the fact. This will not change under CRA; as a result, with CRA unanticipated reserve supply developments will not only continue to produce severe interest rate instability — their impact could be quicker as well as more pronounced, since they would not be dampened by timely open market operations.

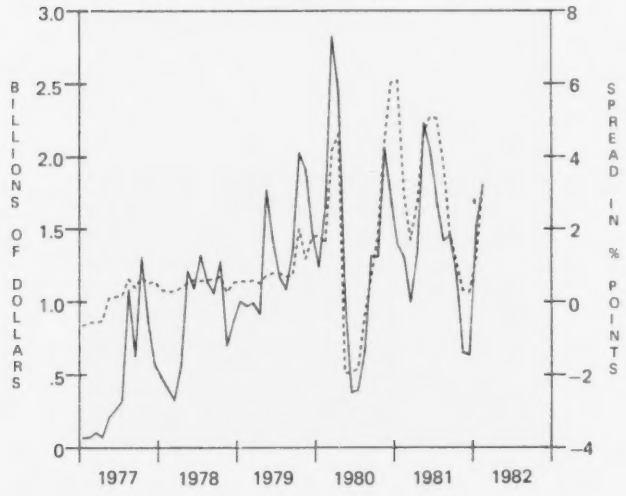
The Fed's control is also limited by the fact that the basic data that the Federal Open Market Committee uses to influence money are unadjusted while the money figures that everyone follows is seasonally adjusted. As the Boston Fed recently warned: "Seasonal patterns in money demand and supply and in uncontrolled factors that affect reserves sometimes change abruptly." To this I would add: it is virtually impossible to set weekly seasonal patterns for any statistic — much less for money, where random events (weather, politics, international developments, mass psychology,

etc.) overwhelmingly determine liquidity preferences of the non-Fed factors, thus changes in the money supply.

On the subject of weekly data, no serious economist thinks for one moment that weekly fluctuations in the money supply mean anything. For one thing, the magnitude of the changes in initially-reported figures frequently differ when revisions are made. For another, many times these changes are reversed in a subsequent week's report. Furthermore, the link between money and the economy — velocity — tends to fluctuate widely and unpredictably. The aggregates, themselves, take on new and unforseeable meaning whenever laws, technology, and sophistication change — which happens too frequently these days. Less volatility could be achieved simply by the Fed issuing monetary statistics less frequently.

Finally, a couple of points to ponder. First, notwithstanding its problems with LRA, velocity, portfolio shifts, seasonal adjustments, and the like, most economists believe that the Fed did a pretty good job of controlling money in 1981. MIB growth wound up the year slightly below the Fed's target, but M2 was slightly above, so, given the problems noted above, it would appear that, on average, the targets were hit. Second, if even greater short-run control is desired, the Fed need not go to CRA. It need only adopt a floating discount rate pegged at a *penalty* level (say, 50 basis points) above the Federal funds rate as proposed in

CHART II
MEMBER BANK BORROWINGS (LINE) VS. THE SPREAD BETWEEN THE FED. FUNDS AND DISCOUNT RATES (DOT)



the Manufacturers Hanover Economic Report of December, 1980. In this way, member bank borrowing would respond sooner to Fed tightening, since the opportunity to obtain reserves at a below-market rate would no longer exist.

As you can see from Chart II, the Fed's ability to control money growth has been hampered by the activities at its discount window. The bigger the spread between the Federal funds rate and the discount rate, the more member banks have sought to satisfy their reserve requirements by borrowing from the Fed. Thus, notwithstanding whatever reductions in nonborrowed reserves the Fed may have aimed for in its open market operations, control over total reserves was less effective than it could have been because of the existence of this "escape valve."

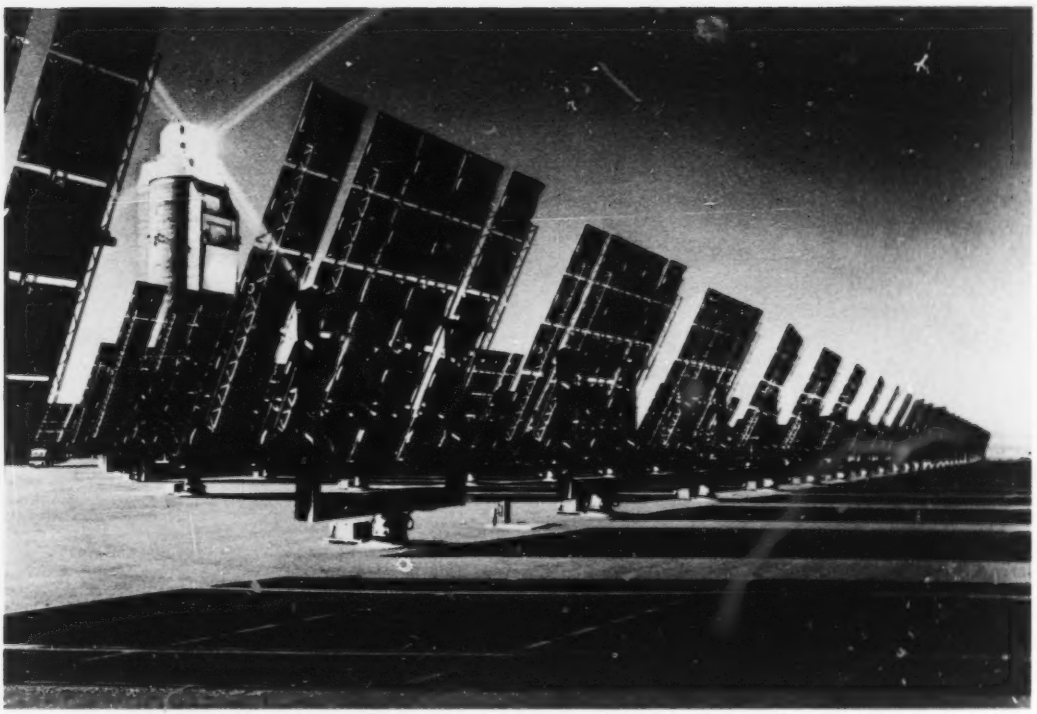
It would therefore appear that the institution of a floating discount rate, rather than a return to CRA, might be all that would be needed for greater control over total bank reserves, hence over money growth. As for CRA, the Federal Reserve Bank of Kansas City, in an exhaustive econometric analysis, recently concluded that "returning to CRA would not appreciably improve the precision of short-, medium-, or long-run monetary control under the nonborrowed reserves operating procedure now being employed by the Federal Reserve." Furthermore, the Bank believes, "a return to CRA accompanied by the adoption of a total reserves operating procedure would *worsen* (italics mine) monetary control."

Fiscal Policy's at Fault

Having said all this, I must conclude by pointing out that no amount of control over money — no matter how precise — can be any more than marginally helpful in reducing interest rates and promoting healthy economic growth so long as the Federal government continues to run large and growing deficits (both on-and off-budget). The Federal Reserve may no longer be monetizing these deficits, but, as Fed Governor Henry Wallich recently pointed out, even non-monetized deficits lead to high rates of inflation — not to mention high interest rates.

Another impediment to lower rates is a fear among market participants that a continuation of the present conflict between the irresistible force of Federal government borrowing and the immovable object of a monetarist-oriented tight money policy by the Federal Reserve might lead to a wave of bankruptcies which would force the central bank to compromise its money growth objectives by acting as lender of last resort, in order to save the financial system. In other words, before monetary policy can even begin to effectively improve economic conditions, fiscal policy must change: Washington's budget deficit must be reduced — not widened as now seems likely.

The finger of blame should be directed at fiscal — not monetary policy. H



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